United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

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To be argued by
DANIEL H. MURPHY, II

P/S

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket Nos. 74-1221 and 74-1490

CITIES SERVICE COMPANY,
Plaintiff-Appellee-Appellant,

—v.—

UNITED STATES OF AMERICA,
Defendant-Appellant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR THE UNITED STATES OF AMERICA

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Cities Service Company,
Plaintiff-Appellee-Appellant,

—v.—

United States of America,
Defendant-Appellant-Appellee.

BRIEF FOR THE UNITED STATES OF AMERICA

Statement of the Issues

1. Whether debt discount arises where a corporate taxpayer issues an obligation in exchange for its own outstanding preferred shares.

2. Whether a corporate taxpayer may gain a deduction for discount when it satisfies its shareholders' rights to accrued dividends and call premium by issuing the shareholders corporate debentures rather than by paying the shareholders in cash.

Statement of the Case

(1) The Nature of the Case and Proceedings Below

This is a tax refund case. On May 28, 1947, the taxpayer Cities Service Company issued 3% debentures in the face amount of $115,246,950 to its preferred shareholders in exchange for its outstanding preferred stock and accrued

dividends (141a).* By a claim for refund filed on March 24, 1964, taxpayer sought to realize bond discount for its 1953 and 1954 tax years on the debentures issued on that exchange. The claims were not allowed and the taxpayer brought this action (6a, 8a-9a).

Both sides moved for summary judgment. The Honorable Walter R. Mansfield, then a United States District Judge for the Southern District of New York, denied both motions in a decision reported at 316 F. Supp. 61 (140a) and found the sole material fact left for trial to be "the value to plaintiff of the preferred and preference shares received by it upon issuance of its debentures." (170a). The Government filed a second motion for summary judgment which was denied by the Honorable Inzer B. Wyatt in a decision reported at 330 F. Supp. 421 (175a). A non-jury trial was had before the Honorable Charles H. Tenney on July 17-19, 1972. Judge Tenney, in an opinion reported at 362 F. Supp. 830 (637a), found the value to taxpayer of the preferred stock received by it to be the fair market value which Judge Tenney set at $86,313,600 (654a).

Judgment was entered on November 20, 1973, granting the taxpayer refunds for 1953 and 1954 arising out of deductions for bond discount of the amortized portion of the difference between the face amount of the debentures and the fair market value of the preferred stock allocable to 1953 and 1954 (663a). The Government appealed; the taxpayer filed a cross-appeal. The time for the filing of the appendix and appellant's brief was extended by stipulation to fifty (50) days after the decision by the United States Supreme Court in *Commissioner* v. *National Alfalfa*, 42 U.S.L.W. 4798 (U.S. May 28, 1974).

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* Parenthetical references with the suffix "a" are to the Joint Appendix. The facts are as found by the trial courts below.

The Government as petitioner and Cities Service as *amicus curiae* both participated in *National Alfalfa.* The Government's position prevailed. *National Alfalfa* is the controlling authority in this case. It determines that no bond discount may ensue where taxpayer issues bonds for its outstanding stock.

(2) Statement of the Facts

On May 28, 1947 the taxpayer Cities Service Company issued thirty-year 3% sinking fund debentures in the aggregate face amount of $115,246,950. The debentures were issued pursuant to a document titled "Cities Service Company—Plan Pursuant to Section 11(e) of the Public Utility Holding Company Act of 1935 For Simplification of Corporate Structure dated November 20, 1946 (as amended February 20, 1947)." (28a). Hearings on the fairness of the Plan had been conducted by the Securities and Exchange Commission pursuant to its regulatory authority under the Public Utility Holding Company Act. On April 24, 1947, the Plan was approved by the SEC (45a). The United States District Court for the District of Delaware signed an order enforcing the Plan on April 27, 1947 (82a). The Plan became effective pursuant to that order on May 27, 1947.

The debentures were issued to the preferred stockholders of Cities Service Company in exchange for all the outstanding preferred stock, all rights appertaining thereto, and all dividend arrearages thereon. At the time of the exchange there were three classes of preferred stock outstanding: 1) a preferred class consisting of 560,600 shares of $6.00 cumulative no par preferred stock carrying an annual dividend of $6.00 and callable at the option of taxpayer at a price of $112.00 per share ($100.00 stated value plus $12.00 call premium) plus accumulated and unpaid dividends; 2) a preference B class consisting of 86,000 shares of 60¢ cumulative no par preferred stock carrying an annual dividend of 60¢ and callable at the option of taxpayer at a

price of $10.60 ($10.00 stated value plus 60¢ call premium) plus accumulated and unpaid dividends; and 3) a preference BB class consisting of 17,700 shares of $6.00 cumulative no par shares carrying an annual dividend of $6.00 and callable at the option of taxpayer at a price of $106.00 ($100.00 stated value plus $6.00 call premium) plus accumulated and unpaid dividends. At the time of the exchange the dividends on the three classes of preferred stock had been passed for fourteen years (143a); the first class was $84.50 in arrears, the second $8.75, and the third $87.50 (145a-146a). The differences between the three classes are not relevant for our purposes and the preferred may be considered as an entity consisting of $58,690,000 stated value, $6,885,000 call premium, and $49,671,950 accrued dividends (150a). The $115,246,950 face amount of the debentures equals the sum of the stated value, call premium and accrued dividends amounts.

Since the debentures were exchanged for the taxpayer's own preferred stock, the exchange was reflected only on the Liabilities column of the taxpayer's balance sheet (35a).* The Assets column remained unaffected (*ibid*). Judge Mansfield put the issue before him as "whether such a reduction or change in a taxpayer's own capital structure may be treated as giving rise to loss or discount." (160a). The trial court went on to hold in the affirmative. The Government disputes that conclusion of law on this appeal.

Judge Mansfield found pursuant to F.R. Civ. P. 56(c), (d), 28 U.S.C., "that the sole material fact actually controverted is the value to plaintiff of the preferred and preference shares received by it upon issuance of its debentures." (170a). Trial was had before the Honorable

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* The $58,690,000 stated value of the preferred stock item and the $19,661,150 accrued dividends item were each cancelled; $36,895,800 was subtracted from the earned surplus. The three adjustments total the $115,246,950 face amount of the debentures.

Charles H. Tenney, United States District Judge for the Southern District of New York, sitting without a jury. Judge Tenney found that the value of the preferred stock received on the exchange was the fair market value, $86,313,600 (654a). Although the Court noted that there was an issue as to whether the consideration historically received by the taxpayer when the preferred was first issued was its stated value, $58,690,000, or a lesser figure, $45,323,846, urged by the taxpayer, that issue was held irrelevant in the light of the Court's determination after the trial (656a).

The taxpayer submitted a proposed judgment which would have permitted taxpayer to recover refunds for pre-1953 years which years were barred by the statute of limitations (657a). The Government submitted a judgment which cured the defect in taxpayer's proposed judgment (663a). The Government's proposed judgment was entered (*ibid.*). The filing of papers on this appeal was adjourned to await the decision in *Commissioner* v. *National Alfalfa*, 42 U.S.L.W. 4798 (U.S. May 28, 1974). The *National Alfalfa* decision was handed down on May 28, 1974. This appeal then came on.

ARGUMENT

POINT I

National Alfalfa determines that no bond discount may ensue on the exchange of taxpayer's debentures for taxpayer's own outstanding preferred stock.

A debenture or bond is a written evidence of debt issued by a corporation and bearing interest. See Internal Revenue Code of 1954, Sec. 171(d) (26 U.S.C.). A debenture is issued for a term certain; at the expiration of

that term, the debenture is redeemed by the issuer at the debenture's par value. Where the debenture is issued at a cash price greater than par value, the difference is bond premium. Where a debenture is issued at a cash price less than par value, the difference is bond discount. Bond discount (including commissions for marketing the bonds) is deductible. *Helvering* v. *Union Pacific R.R.*, 293 U.S. 282, 292 (1934). Bond discount is not made deductible specifically by the Tax Code; deduction is had under the interest (Sec. 163(a))* and the loss (Sec. 165(a))* provisions.

On May 28, 1974, the Supreme Court decided *Commissioner* v. *National Alfalfa,* 42 U.S.L.W. 4798, a bond discount case which is directly in point and which disposes of this appeal in the Government's favor. The taxpayer in *National Alfalfa* issued 18 year, 5% debentures each in the face amount of $50.00 plus a stock warrant to its preferred shareholders share for share in exchange for 5% cumulative $50 par preferred shares carrying an annual dividend of $2.50 and callable at the option of taxpayer at $51.00. The dividends were $10.00 in arrears at the time of the exchange. The market value of the preferred was $33.00 per share at the time of the exchange. The Court held that no bond discount was incurred on the exchange, 42 U.S.L.W. at 4804. Mr. Justice Blackmun spoke for the Court, *ibid*:

> " * * * The cost of the capital invested in the corporation was the same whether represented by the preferred or by the debentures, and was totally unaffected by the market value of the shares received at the time of the issuance of the debentures. Accordingly, while recognizing the alteration which

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* The corresponding 1939 Internal Revenue Code sections on interest (Sec. 23(b)) and loss (Sec. 23(f)) are substantially identical to those in the 1954 Code.

> did occur in the corporation's capital structure, we conclude that the substitution by NAD of its debentures for its previously outstanding preferred, without more, did not create an obligation to pay in excess of an amount previously committed, or establish the base upon which debt discount can arise."

Similarly, Cities Service Company did no more than substitute "its debentures for its previously outstanding preferred"; as its balance sheet reveals, the exchange was no more than an "alteration * * * in the corporation's capital structure"; or as Judge Mansfield found below "a reduction or change in a taxpayer's own capital structure" (160a). *National Alfalfa* holds that a restructuring of a corporation's capital structure (i.e., rearranging the corporate taxpayer's liabilities column on its balance sheet without increasing its assets column) does not "establish the base upon which debt discount can arise." 42 U.S.L.W. at 4804.

POINT II

National Alfalfa viewed in the context of the historical treatment of bond discount in the federal courts rejects the theory applied by the trial court and holds that no bond discount may ensue on the exchange of bonds for outstanding stock.

Helvering v. *Union Pacific R.R.*, 293 U.S. 282 (1934), determined that bond discount recognized by the tax laws could ensue when bonds were issued for cash. Although the applicable tax regulations treated bond discount as a loss realized on their redemption which loss could be prorated over the life of the bonds, bond discount and bond premium could be considered more comfortably as interest, "merely a means of adjusting the transaction to the cur-

rent market rate for money based upon the credit of the debtor and the availability of money for lending by the creditor." *San Joaquin L & P Corp.* v. *McLaughlin,* 65 F.2d 677, 679 (9th Cir. 1933).

Union Pacific used both the loss concept and the interest concept in reasoning to its conclusion:

> "Both commissions and discount, as the Government concedes, are factors in arriving at the actual amount of interest paid for the use of capital procured by a bond issue. The difference between the capital realized by the issue and par value which is to be paid at maturity, must be added to the aggregate coupon payments in order to arrive at the total interest paid. Both discounts and commissions are included in this difference. If the difference be viewed as a loss resulting from the funding operation, it is one which is realized only upon payment of the bonds at maturity." 293 U.S. at 286.

When the Courts considered bond discount in situations where bonds were issued for non-cash property, one line of cases from the Circuit Courts of Appeals followed the interest concept and one line of cases from the Court of Claims followed the "loss resulting from the funding operation" concept. Judge Mansfield's opinion below (159a) attempted to draw the two lines together. Then the Supreme Court in accepting *Commissioner* v. *National Alfalfa,* 42 U.S.L.W. 4798 (U.S. May 28, 1974), to resolve the conflict, 42 U.S.L.W. at 4800, held that the exchange of bonds for preferred stock did not increase the capital assets of the taxpayer, was not in effect a borrowing, and hence did not "establish the base upon which debt discount can arise. " 42 U.S.L.W. at 4804. A page or two on the history of bond discount as treated in the cases may help to put the logic and the holding of *National Alfalfa* in perspective.

The interest cases start with *Dodge Brothers* v. *United States,* 118 F.2d 95 (4th Cir. 1941), in which debentures were issued for cash at par and the proceeds used to buy the Dodge motor car business. Since the bonds were issued at par, the Court found no discount reasoning that amortized discount "is but a concept devised for accounting convenience and is limited by the resemblance to interest." 118 F.2d at 104. In *American Smelting* v. *United States,* 130 F.2d 883 (3d Cir. 1942), the taxpayer issued debentures in exchange for the taxpayer's outstanding preferred stock. The Third Circuit held that tax deductible bond discount arose out of the exchange, 130 F.2d at 885:

> "We believe that the discount is still to be treated as additional interest when the subject matter of the loan is stock instead of cash. It is clear in both cases that the discount, or additional interest, is determined at the time the bonds are issued. Thus, when the investor is paid the face amount of the bond at maturity, he is taxable for the difference between that sum and the cost of the bond. Here the cost of the bond is the fair market value of the stock at the time the corporate obligations were exchanged."

In *Montana Power Co.* v. *United States,* 232 F.2d 541, 543-544 (3d Cir.), *cert. denied,* 352 U.S. 843 (1056), no discount was allowed as the taxpayer failed to prove the fair market value of the preferred stock exchanged at the trial. The Tenth Circuit allowed discount on the same fair market formula applied by the Third Circuit. *Atchison, Topeka & Santa Fe R.R. Co.* v. *United States,* 443 F.2d 147, 150 (10th Cir. 1971); *National Alfalfa* v. *Commissioner,* 472 F.2d 796 (10th Cir. 1973), *rev'd,* 42 U.S.L.W. 4798 (U.S. May 28, 1974).

Meanwhile, the Court of Claims decided a pair of bond discount cases on a "loss resulting from the funding operation" theory. *Erie Lackawanna R. Co.* v. *United States,*

422 F.2d 425 (Ct. Cl. 1970); *Missouri Pacific R. R.* v. *United States*, 427 F.2d 727 (Ct. Cl.), *modified on rehearing*, 433 F.2d 1324 (Ct. Cl. 1970), *cert. denied*, 402 U.S. 944 (1971). In *Erie Lackawanna*, the taxpayer exchanged $100.00 face debentures for $100.00 par preferred plus $15.00 accrued dividends share for share. Even though the market value of the stock was less than the face amount of the bonds, the Court found no recognizable bond discount on the exchange, 422 F.2d at 430:

> "* * * [W]e do hold that debt discount is not available in situations where the maturity value of the bonds is the same as the [original issue price] amount received in payment for the stock."

As the Court had put the matter at an earlier point, 422 F.2d at 430:

> "In effect, we are simply saying that the plaintiff has not been hurt, nor has it experienced any loss as a result of the transaction in question."

The first *Missouri Pacific* opinion held the fair market value of the old bonds and stock "meaningless", 427 F.2d at 730, where new bonds were issued for old bonds and stock. The Court then concluded, 427 F.2d at 734:

> "That when exchanged for new bonds, the [debt securities and stock given up to the taxpayer] should not be evaluated by the use of fair market value. Instead, the stocks should be given a value equal to the amount originally paid for them, and the value of the bonds should be determined by their maturity value as of the time of issue."

Judge Mansfield attempted in his opinion below to synthesize the cases using the fair market value interest theory with the Court of Claims cases using the original issue

price loss theory. The Court took as its touchstone the loss theory (159a-160a):

> "The general conclusion that we draw is that where a true loss has been sustained by the taxpayer's issuance of obligations payable at their face value at some future date, the debt-discount concept, which is at best a more or less arbitrary creation, will not be construed in a technical manner to bar the taxpayer from deducting the loss as a discount. In short, the difference between the face amount of a bond (which the issuer agrees to pay upon maturity) and the lesser consideration received upon its issuance is normally considered a discount in the absence of circumstances indicating that the difference was not intended as a discount."

Judge Mansfield then consolidated the loss cases with the interest cases by holding the original issue price consideration to be the floor (165a-166a) and the actual value of the stock to taxpayer the ceiling (167a-168a) of the consideration received. In computing the latter value the market price of the shares was held a relevant datum (167a) although not conclusive.

A different synthesis of the two lines was performed by the Fifth Circuit in *Claussen's Inc.* v. *United States*, 469 F.2d 340 (5th Cir. 1972), an exchange of old common stock for new common stock and debentures. The *Claussen's* Court found no deductible bond discount on the exchange, since the corporate taxpayer procured no new capital on the exchange, 469 F.2d at 344:

> "However, it seems clear that bond discount should arise only where the use of capital is actually procured by a bond issue. *Helvering* v. *Union Pac., supra.* In other words, bond discount might properly be incurred in economic terms in a transaction involving some form of borrowing by a corporation at a cost to it of something more than the

coupon rate of interest, or conversely where something of real value to the corporation is surrendered in exchange for its new bonds."

Commissioner v. *National Alfalfa*, 42 U.S.L.W. 4798 (U.S. May 28, 1974), was decided against that background. The decision is in four parts. In the first part, the Court set the loss cases (followed by the Tax Court below) against the interest cases (followed by the 10th Circuit). 42 U.S.L.W. at 4800. In the second part, the Court distinguished cases such as *Nassau Lens* v. *Commissioner*, 308 F.2d 39 (2d Cir. 1962)*, where bonds were issued for property which property was neither cash nor stock, from the issue in *National Alfalfa* and the issue here, "whether debt discount arises where a corporate taxpayer issues an obligation in exchange for its own outstanding preferred shares." 42 U.S.L.W. at 4801. The Court then made clear that bond discount, when deductible, is deductible under the interest theory. 42 U.S.L.W. at 4802. The test adopted was that foreseen by the Fifth Circuit in *Claussen's*, *supra*, 469 F.2d at 344:

> "* * * the relevant inquiry in each case must be whether the issuer-taxpayer has incurred, as a result of the transaction, some cost or expense of acquiring the use of capital." 42 U.S.L.W. at 4802.

The third part then disapproved the hypothetical simile used in *American Smelting* v. *United States*, 130 F.2d 883, 884 (3d Cir. 1942); *Atchison, Topeka & Santa Fe R.R.* v. *United States*, 443 F.2d 147, 152 (10th Cir. 1971); and Judge Mansfield below (157a) where the exchange of bonds for stock was likened to the issuance of bonds for cash and

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* In *Nassau Lens*, the debentures were at the extreme end of the spectrum since they paid no interest at all.

the use of that cash to purchase the stock, 42 U.S.L.W. at 4802-4803.*

Finally, in the fourth part, the Court applied its test set out in the second part of its opinion to the facts of the *National Alfalfa* exchange, 42 U.S.L.W. at 4803.

> "It has not been demonstrated that NAD, by the exchange, incurred any additional cost for the use of capital. NAD merely replaced that portion of its paid-in capital represented by its preferred with paid-in capital represented by its debentures. From the perspective of the corporation, the transaction was the exchange of one form of interest or participation in the corporation for another. But the corporate assets were neither increased nor diminished. [Footnote omitted.]
>
> "To be sure, upon the issuance of its debentures, NAD assumed a fixed obligation to pay at a date cer-

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* The third part also rejected the factual analysis by the lower courts in *National Alfafa*. Certainly when an exchange is performed between a corporation and its shareholders there is always the possibility that the exchange is a cover for the declaration of a dividend. Even here the bonds were selling at 91⅞ on the date of the exchange (151a) or some $105,883,135, so that if the preferred was only worth $86,313,600 the difference or $19,-569,535 was a gift by Cities Service to its preferred shareholders. Thus, the exchange here in suit masked a $19,569,535 dividend to the preferred shareholders. When the lower courts here granted a deduction for bond discount for the difference between $115,246,950 and $86,373,600, at least $19,569,535 of that discount was a deduction for a dividend paid on the exchange. Indeed in the third part of *National Alfalfa,* the Court recognized the impossibility of telling, in an exchange (such as this one) which is "insulated from market forces", whether "the difference between the claimed * * * per share value of [the] preferred and the face amount of the debentures is attributable to debt discount" or whether it is attributable to the corporation's desire to pay a dividend to the preferred shareholders. 42 U.S.L.W. at 4802 and 4803.

tain. The transaction, therefore, perhaps could be said to be something more than a mere reshuffling of the corporation's capital structure [Citation omitted], since a creditor was substituted for a holder with an ownership interest. [Footnote omitted.] But again, when viewed from the corporation's perspective, * * * there has been no new capital acquired and no additional cost incurred in retaining the old capital. [Citation omitted.]

"In obvious explanation of this, NAD originally received $50 cash for each share of preferred. Although it was not obligated to repay that sum at any fixed time, it made use of that cash pursuant to the provisions of its articles, including both the sinking fund and the redemption-liquidation provisions. Upon the exchange, the corporation cancelled the preferred, and thus eliminated the preferred stock account upon its books, together with the preferred's attendant obligations. The market value of the preferred at that moment bore no direct relationship to the amount of funds on hand. The capital 'freed' by the cancellation of the preferred was merely transferred to the liability account for the debentures. No new capital was involved. See *Claussen's Inc.* v. *United States,* 469 F.2d 340 (CA 5, 1972). [Footnote omitted.]"

The Court then went on to show that the debentures issued by *National Alfalfa* were "fairly reflected in" or substantially equal to the preferred stock received. 42 U.S.L.W. at 4803, 4804. That precise finding was made by the SEC and by the United States District Court of Delaware when the exchange here in suit was approved in 1947 (66a; *In re Cities Service Co.,* 71 F. Supp. 1003, 1005 (D. Del. 1947)). Obviously, 3% interest paid by Cities Service Company on $115,246,950 face amount of debentures is equivalent to the 6% dividends accruing annually on the $58,690,000 stated value of the preferred stock exchanged.

The conclusion in *National Alfalfa* concludes as well the issue before this Court on this appeal, 42 U.S.L.W. at 4804.

> "* * * Accordingly, while recognizing the alteration which did occur in the corporation's capital structure, we conclude that the substitution by NAD of its debentures for its previously outstanding preferred, without more, did not create an obligation to pay in excess of an amount previously committed, or establish the base upon which debt discount can arise.
>
> "In sum, the alteration in the form of the retained capital did not give rise to any cost of borrowing to NAD. The fact that the preferred may have been worth something in the neighborhood of only \$33 per share on the market at the time of the exchange was of no consequence, since NAD was not required to go into that market and purchase those shares. It was able, instead, to obtain the preferred merely by cancelling the \$50 obligation per share on its equity account and transferring that amount to its debt account. It is in this sense that an exchange of a corporation's own outstanding preferred for newly issued debt obligations may differ, in the tax sense, from an exchange for other property. Such other property—for example, inventory or the stock of another corporation—does not equate with a previous contribution of capital which can continue to be utilized by the corporation at no cost upon cancellation of the preferred equity account."

The balance sheet for Cities Service demonstrates a similar substitution. Upon the issuance of the debentures, the taxpayer cancelled \$58,690,000 representing the stated value of the preferred and \$19,661,150 representing preferred dividends passed before 1938. The dividends passed since 1938 had been carried as earned surplus (35a-36a).

The balance of the $115,246,950 face amount of debentures was obtained by subtracting $36,895,800 from the earned surplus account (35a). It would be sophistry to deny a deduction in *National Alfalfa* because the equity account was labelled stated capital and to grant it here because the equity accounts are labelled stated value, accrued dividends and earned surplus. Whatever the label, the exchange in *National Alfalfa* and the exchange here did no more than shift items in the taxpayer's equity account to its debt account. The market value of the preferred was held "of no consequence" in *National Alfalfa;* the $86,313,600 market value found by Judge Tenney (654a) pursuant to Judge Mansfield's order (170a, 167a-168a) is similarly "of no consequence", for Cities Service was not required to go into the market to purchase those shares. It was able instead to obtain the preferred merely by cancelling the attendant obligations on its equity account and transferring that amount to its debt account. As *National Alfalfa* holds, that form of alteration in a taxpayer's capital structure, without more, does not "establish the base upon which debt discount can arise." 42 U.S.L.W. at 4804.

POINT III

The trial court erred in allowing the taxpayer to deduct discount attributable to dividends and call premium.

The preferred stock received by Cities Service on the exchange had a stated value of $58,690,000, accrued unpaid dividends of $49,671,950, and a call premium of $6,885,000. The taxpayer argues further that the market value of the consideration received on issuance of the $58,690,000 stated value preferred was only $45,323,846. The $115,246,950 face amount of the bonds issued equals the total of the stated value, accrued dividends and call premium of the preferred received on the exchange. To the extent any bond discount

is allowed on this exchange, the taxpayer is receiving a discount for satisfying its shareholders' rights to call premium, dividends, and, if the taxpayer should prevail on its most extreme theory, the difference between stated value and the fair market value of the property received when the stock was issued originally. Now, none of these items (dividends, call premium, excess in stated value) are deductible items. See *Kentucky Utilities Co.* v. *Glenn,* 394 F.2d 631, 636 (6th Cir. 1968). If Cities Service had redeemed its outstanding preferred for cash, no portion of the redemption price would be deductible to Cities Service. This case presents in stark form the question whether a corporation should gain a deduction for discount when it satisfies shareholders' rights by issuing its obligations rather than payment in cash.

Here, we have the added factor that the exchange was pursuant to a corporate simplification under Section 11(e) of the Public Utilities Holding Company Act of 1935, 15 U.S.C. § 79k(e). Judge Mansfield reasoned that the call premiums and accrued dividends lost their character as such, because the exchange here was something less than a "redemption". (156a-157a). The lower court continued (162a-163a):

> "Since the transaction amounted to a conversion of preferred stock and hopes for eventual payment of accrued accumulated dividends into creditors' claims, there is no reason to treat the issuance of debentures as a direct payoff of the elements of the call price that would be payable if there had been a redemption. In short if cash had been paid pursuant to the redemption provisions of the charter, there would not have been any deductible discount. But cash was not paid and there was no redemption."

The trial court erred in holding "there is no reason to treat the issuance of debentures as a direct payoff of each of the elements of the call price that would be payable if there

had been a redemption." The SEC in finding the plan "fair and equitable" to the preferred shareholders specifically relied upon the face amount of the debentures preserving the full call price on the preferred (66a-67a):

> "By operation of the Plan the preferred and preference stockholders of Cities will become its creditors in principal amounts equivalent to the respective redemption prices of their present holdings of preferred and preference stocks. Of course, in exchange for such creditor status, the preferred and preference shareholders will surrender, among other things, their existing claims to payment in full of accumulated dividend arrearages before any income may be distributed to the common shareholders. However, as creditors they will be the senior security holders of Cities [footnote omitted] and will enjoy an enforceable right to a fixed claim to Cities' earnings. * * *
>
> "Cities' financial structure as heretofore discussed makes it extremely unlikely that Cities could presently undertake to redeem or refinance its preferred stocks. However, it is to be noted that under the exchange provisions of the Plan the preferred and preference shareholders will have preserved to them the precise call prices attaching to their present holdings since upon any call of the new Debentures, which are callable at their principal amount, the holders will receive the same amount of cash as they would have received in connection with any call of the preferred and preference shares. [Footnote omitted]."

The Delaware District Court also found to the same effect when it approved the Plan. *In re Cities Service Co.*, 71 F. Supp. 1003, 1005 (D. Del. 1947).

The Supreme Court decisions under Section 11(e) of the Public Utility Holding Company Act of 1935 demonstrate that Judge Mansfield was in error in refusing to

accord to taxpayer's debentures the function accorded to them by the Securities and Exchange Commission. Those decisions are *Otis & Co.* v. *S.E.C.*, 323 U.S. 624 (1945); *S.E.C.* v. *Central-Illinois Corp.*, 338 U.S. 96 (1949); and *Niagara Hudson Power Corp.* v. *Leventritt*, 340 U.S. 336 (1951). Of these, the most significant for present purposes is the *Central-Illinois* decision. In that case the holding company had outstanding three issues of preferred stock, and the plan approved by the S.E.C. called for the preferred shareholders to receive in cash the amounts of the stated values, the accrued dividends, and the call premiums on the preferred shares. The District Court eliminated the amount of the call premiums, and the Court of Appeals approved, though it held that the District Court should have returned the case to the Commission rather than enforcing the plan as it had amended it. The Supreme Court reversed both Courts and held that the Commission's order should have been sustained. Although it reiterated the *Otis & Co.* decision that charter provisions were not necessarily controlling if investment values could otherwise be preserved, it held also that the full priorities rule prevailed in Section 11(e) proceedings, as in other reorganizations, 338 U.S. at 139-140, and upheld the Commission's implementation of that rule. In the *Niagara Hudson* case, the Court again, 340 U.S. at 346-347, held that "The informed judgment of the Commission, rather than that of the market, has been designated by the Act as the appropriate guide to fairness and equity within the meaning of the Act." In *Federal Liquidating Corp.* v. *S.E.C.*, 187 F.2d 804, 810 (2d Cir.), *cert. denied*, 341 U.S. 949 (1951), this Court put the following gloss on the quoted sentence from *Niagara*:

> "We take this to mean that the appraisal of an investment security, involving as it must the forecast of its future earnings, enjoys a rather larger measure of invulnerability to review by courts than even that customarily accorded to administrative findings."

These decisions make it clear that taxpayer's debentures were issued on the basis approved by the S.E.C., *i.e.,* in payment dollar-for-dollar for stated capital, accrued dividends, and the call premium appurtenant to the preferred shares. It is certainly clear that an obligation issued as a dividend gives rise neither to loss nor to discount. *Claussen's Inc.* v. *United States,* 469 F.2d 340, 345 (5th Cir. 1972).

The effect of the exchange in suit has been judicially determined. Its effect was to freeze the shareholders' rights to accrued dividends and call premium in debentures (66a-67a). The Supreme Court has held such determinations are not to be attacked directly. In effect, the trial court here attacked that determination collaterally. The effect of that attack was to allow taxpayer a deduction in the form of bond discount for non-deductible items (dividends and call premium). Thus the trial court erred.

CONCLUSION

The decision of the trial court allowing deductible discount on the exchange of bonds for taxpayer's outstanding preferred stock should be reversed.

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Respectfully submitted,

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